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IN THE

Supreme Court of the United States

OCTOBER TERM, 1955

No. 20

CORN PRODUCTS REFINING COMPANY,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

(Consolidated Proceedings.)

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

REPLY BRIEF FOR THE PETITIONER

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INDEX

	PAGE
Statement	1
Argument	
I. Petitioner's commodity futures transactions were capital asset transactions under the Internal Revenue Code of 1939	3
A. Section 117(a) of the Internal Revenue Code governs petitioner's commodity transactions	3
1. Legislative History and Intent: Section 117(a) Means What It Says	4
2. Statutory Reenactment Gives the Regulations Legislative Sanction	7
3. *Burnet* v. *Harmel* Does Not Support Respondent	8
4. The Present Case Does Not Involve Attempt to Convert Ordinary Income to Capital Gain	11
5. Assets Used in Hedging Are Not Excluded from Capital Assets	13
B. Petitioner's commodity futures transactions do not fall within the so-called "Hedging Exception to Section 117"	16
1. Respondent Took an Inconsistent Position in Prior Cases	17
2. Petitioner Merely Shifted the Risk of Loss	20
3. Respondent's Two Charts Are Misleading	21
a. Chart No. 1	21
b. Chart No. 2	22

PAGE

4. The Commodity Exchange Authority Has Held Petitioner Was Not Hedging 23

5. Taxpayers' Intent Is of No Significance 25

6. Petitioner—the Legitimate Capitalist 26

7. Conclusion 28

II. Commodity futures transactions are subject to the wash sales provisions of Section 118 of the Internal Revenue Code 29

A. The futures contracts purchased and sold were substantially identical 29

B. Futures contracts are securities within the meaning of the term as used in Section 118 31

Conclusion 33

Appendix A 35

Table of Cases Cited.

Addison v. *Holly Hill Co.*, 322 U. S. 607 (1944) 4, 13

Battelle, Kenneth S., 47 B. T. A. 117 (1942) 15n

Brooks v. *St. Louis-San Francisco Ry. Co.*, 180 F. 2d 185 (8th Cir., 1950) 4, 13

Burnet v. *Harmel*, 287 U. S. 103 (1932) 8, 9, 13

Clark v. *Commissioner*, 19 T. C. 48, 1952, appeal dismissed June 18, 1953 (9th Cir.) 12

Commissioner v. *Farmers & Ginners Cotton Oil Co.*, 120 F. (2d) 772 (5th Cir. 1941), cert. denied, 314 U. S. 683 (1941) 15n, 17

Commissioner v. *The Bagley & Sewall Co.*, 221 F. (2d) 944 (2nd Cir. 1955) 12

PAGE

Commissioner v. *Wheeler*, 324 U. S. 542 (1945) 8
Corn Products Refining Co., In re, 13 Agric. Dec. 1117 (1954) 3, 23, 24
Cunard S. S. Co. v. *Mellon*, 262 U. S. 100 (1923) 4, 13

Doyle v. *Commissioner*, 102 F. (2d) 86 (4th Cir., 1939) 11

Fisher v. *Commissioner*, 209 F. (2d) 513 (6th Cir., 1954), certiorari denied 347 U. S. 1014 (1954) .. 11
Fulton Bag & Cotton Mills, 22 T. C. 1044 (1954) ... 15n, 26

Grote, Ben, 41 B. T. A. 247 (1940) 15n

Harriss v. *Commissioner*, 143 F. (2d) 279 (2nd Cir., 1944) 32
Helvering v. *Reynolds Co.*, 306 U. S. 110 (1939) 8
Helvering v. *Smith*, 90 F. (2d) 590 (2nd Cir., 1937) .. 11
Hogg v. *Allen*, 105 F. Supp. 12 (M. D., Ga.), affirmed on this point *sub nom.*, *Edwards* v. *Hogg*, 214 F. (2d) 640 (5th Cir., 1954) 12
Hort v. *Commissioner*, 313 U. S. 28 (1941) 11

Kieselbach v. *Commissioner*, 317 U. S. 399 (1943) 11

Lucas v. *Earl*, 281 U. S. 111 (1930) 11

Makransky, Dorothy, Estate of, 5 T. C. 397 (1945); aff. 154 F. (2d) 59 (3rd Cir. 1946) 15n, 25
Moore Ice Cream Company v. *Rose*, 289 U. S. 373 (1933) 4, 13

National Lead Co. v. *United States*, 252 U. S. 140 (1920) 8

Rhodes' Estate v. *Commissioner*, 131 F. (2d) 50 (6th Cir., 1942) 11
Richfield Oil Corporation v. *State Board*, 329 U. S. 69 (1946) 4, 13

Shuster v. *Helvering*, 121 F. (2d) 643 (2nd Cir., 1941) 11
Stewart Silk Corp., 9 T. C. 174 (1947) 15n

Tennessee Egg Co., 47 B. T. A. 558 (1942) 15n, 25

PAGE

Trenton Cotton Oil Co. v. *Commissioner*, 147 F. (2d) 33 (6th Cir., 1945), rehearing denied, 148 F. (2d) 208 (6th Cir., 1945) 15n, 18, 31, 33

United States v. *New York Coffee & Sugar Exchange, Inc.*, 263 U. S. 611 (1924) 26

Valley Waste Mills v. *Page*, 115 F. (2d) 466 (5th Cir., 1940), certiorari denied, 312 U. S. 681 (1941) .. 32

Western Wine & Liquor Co., 18 T. C. 1090 (1952), appeal dismissed 205 F. (2d) 420 (8th Cir.) 12

OTHER AUTHORITIES CITED

Commodity Exchange Act, Section 4(c) 32

Discussion—Senate (Cong. Rec. Vol. 78) 6

General Counsel's Memorandum 17322 (XV-2 Cum. Bul. 151) 13, 15, 16

Internal Revenue Code of 1939:

Section 117 ..... 13, 14
Section 117(a) 3, 4, 12, 13, 14, 15, 16, 28
Section 117(g) 14
Section 117(l) 14
Section 118 ..... 29, 30, 31, 32
Section 502(c) 15

Internal Revenue Code of 1954:

Section 1221 ..... 14, 14n, 35
Section 1233 14
Section 1233(a) 14

Regulations 62 Art. 1651, 1921 Revenue Act 7

Regulations 69 Art. 1651, 1926 Revenue Act 7

Regulations 74 Art. 501, 1928 Revenue Act 7

Regulations 77 Art. 501, 1932 Revenue Act 7

PAGE

Regulations 86, 1934 Revenue Act 7

Regulations 94, 1936 Revenue Act 7

Regulations 101, 1938 Revenue Act 7

Regulations 103, 1939 Internal Revenue Code 7, 8

Report—Conference Committee (73d Cong., 2d Sess., H. Rept. 1385) 5, 6

Revenue Act of 1921 ..... 4, 7
Section 206(a) 4

Revenue Act of 1924 5
Section 208(a)(1) 8, 9

Revenue Act of 1926 5

Revenue Act of 1928 5

Revenue Act of 1932 5

Revenue Act of 1934, Section 117(b) 5, 8

Revenue Act of 1938 7

Revenue Act of 1942 7

Rich & Rippe, "Tax Aspects of Commodity Futures Transactions with a Business Purpose", 2 Tax Law Review 541 at 559 ..... 16n

Ways and Means Committee of the House Report (67 Congress, First Session, House Report 350) 19

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Statement

The facts with respect to the issues have been previously brought out at pages 5 through 11 of petitioner's initial brief and pages 3 through 11 of respondent's brief. They will not be further set forth in this Reply Brief except to correct two misleading impressions contained in the respondent's brief.

a) Petitioner's sales policy, which was uniform in all years here in question, permitted the buyer to pay

the *lower of two prices, the contract price or the market price on the date of delivery* (Exhibit 10, R. 67, 105 and 203). Petitioner also had the *policy of permitting its customers to cancel unexecuted portions of orders* for cerelose or feed in their discretion. The Tax Court so found (R. 203). These cancellations were frequent, unpredictable, and at times substantial (R. 69). Respondent in footnote 19 at page 41 of his brief questioned the correctness of this assertion. However, the record discloses (R. 69) that 11.1% of the cerelose orders in 1939 were cancelled. In 1940, 62% of cerelose orders were cancelled. Cerelose, which is a corn sugar, represented almost 16% of petitioner's business in those years (R. 69).

b) One other misleading impression requires correction. Respondent stated at page 8 of his brief that the proceedings brought against petitioner in 1940 by the Commodity Exchange Authority were dismissed because petitioner was upheld in its contentions. The record does not support this statement. Frank H. Hall, a Vice President of the petitioner, testified (R. 72) that the complaint was withdrawn and the action dismissed. There was no decision of the Commodity Exchange Authority on the merits. The fact is that petitioner had commenced to liquidate its futures position with the advent of World War II. (See Commissioner's Chart No. 1 following page 67 of respondent's brief.) The question had simply become moot. This is further borne out by the fact that when Petitioner resumed futures purchases after

the war, the Commodity Exchange Authority commenced a similar action which resulted in a decision against petitioner. *In re Corn Products Refining Co.*, 13 Agric. Dec. 1117 (1954).

There is no dispute about the balance of the facts in this proceeding.

ARGUMENT

I

Petitioner's commodity futures transactions were capital asset transactions under the Internal Revenue Code of 1939.

A. Section 117(a) of the Internal Revenue Code governs petitioner's commodity transactions.

Respondent's argument on this point generally seems to be as follows (Br. 16-30):

> Although Section 117(a) is specific and unambiguous and includes within its provisions *specific* directions as to the tax treatment of *all* assets *whether or not connected with a trade or business* the section doesn't quite mean what it says. Thus the petitioner's corn futures, implicitly capital assets under the statute, should be treated as other than capital assets, even though the statute permits no such exception.

Petitioner contends that its commodity futures transactions fall within the scope of Section 117(a). That section defines capital assets in a manner which respondent states is unusual (Respondent's Brief, page 18). In point of fact, the method of definition is to set forth a general rule that all assets are capital assets *whether or not connected with the taxpayer's trade or business* unless they fall within the specific enumerated exclusions. Assets used in hedging transactions do not fall within any of these exclusions. Where a statute sets up a general rule and enumerates specific exceptions, as a matter of statutory construction further exceptions by way of *mere implication* are not permissible. *Richfield Oil Corporation* v. *State Board*, 329 U. S. 69 (1946); *Moore Ice Cream Company* v. *Rose*, 289 U. S. 373 (1933); *Cunard S. S. Co.* v. *Mellon*, 262 U. S. 100 (1923); *Addison* v. *Holly Hill Co.*, 322 U. S. 607 (1944); *Brooks* v. *St. Louis-San Francisco Ry. Co.*, 180 F. 2d 185 (8th Cir., 1950).

1. Legislative History and Intent: Section 117(a) Means What It Says

The general statutory distinction between capital and non-capital assets first appeared in Section 206(a) of the Revenue Act of 1921:

> "The term 'capital assets' as used in this section means property acquired and held by the taxpayer for profit or investment for more than two years (whether or not connected with his trade or business), but does not include property

held for the personal use or consumption of the taxpayer or his family, or stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year."

This concept was continued with slight modifications in the Revenue Acts of 1924, 1926, 1928 and 1932. In 1934 the specific exclusions above were made even more precise by eliminating the holding period test and adding the matter italicized below:

"Section 117. Capital Gains and Losses.

(b) Definition of Capital Assets.—For the purposes of this title, 'capital assets' means property held by the taxpayer (whether or not connected with his trade or business), but does not include stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale *to customers* in the *ordinary* course of his trade or business."

The purpose of inserting the concept "to customers in the ordinary" is clearly set forth in the Committee Report:

"* * * The Senate amendment confines the exclusion to property held primarily for sale to customers in the ordinary course of the taxpayer's trade or business, thus making it impossible

to contend that a stock speculator trading on his own account is not subject to the provisions of section 117. The House recedes." (p. 22). Report—Conference Committee (73d Cong., 2d Sess., H. Rept. 1385).

In this connection it should be noted that the commodity futures in this case were not held by petitioner for sale to customers (R. 32).

That Congress was disturbed by the impossibility of a taxpayer getting a full deduction for a legitimate loss on the sale of a business asset is amply demonstrated by the following:

"Mr. Reed. * * * We have been trying to work out some method by which credits could reasonably be given for obsolete property which is sold for salvage. As will be seen, under this amendment, the only loss that is deductible is a loss on property normally carried for sale to customers. It is conceivable that a railroad company, for example, finds that while a locomotive is useless, it has a salvage value as scrap. Probably most of the deductions can be taken in the annual deductions for obsolescence, but if there remained a loss between the book value of such a locomotive and the amount for which it was sold to the junk dealer, under this language the loss could not be deducted. * * *" (p. 5962). Discussion—Senate (Cong. Rec. Vol. 78):

The problem to which Senator Reed referred above, was handled by making further precise exclusions in the 1938 and 1942 Acts to the statutory definition of capital assets when the exclusions for depreciable property and land used in a business were added.

These changes over the years amply demonstrate Congress's meticulous attention to precision in the definition of capital assets and the exclusions therefrom.

2. Statutory Reenactment Gives the Regulations Legislative Sanction

The phrase, "whether or not connected with his (taxpayer's) trade or business", has appeared in every Revenue Act since 1921 as a part of the definition of capital assets. Respondent has recognized this in his regulations throughout past years. For example in the regulations governing the distinction between capital and ordinary assets the phrase is quoted from the various pertinent Revenue Act sections, and appears in the following:

Reg. 62 Art. 1651, 1921 Revenue Act
Reg. 69 Art. 1651, 1926 Revenue Act
Reg. 74 Art. 501, 1928 Revenue Act
Reg. 77 Art. 501, 1932 Revenue Act

While the phrase itself was omitted from Reg. 86 (the Revenue Act of 1934), Reg. 94 (the Revenue Act of 1936), Reg. 101 (Revenue Act of 1938) and Reg. 103 (Internal Revenue Code of 1939), the

concept was expressed in the following manner in those Regulations:

> "The term 'capital assets' includes all classes of property not *specifically* excluded by Section 117(a)(1)." (Emphasis supplied.)

The definition contained in the regulations set forth so often repeated must be deemed to have received legislative sanction. *Helvering* v. *Reynolds Co.*, 306 U. S. 110, 114-115 (1939); *National Lead Co.* v. *United States*, 252 U. S. 140, 146-147 (1920); *Commissioner* v. *Wheeler*, 324 U. S. 542, 547, fn. 10 (1945).

3. *Burnet* v. *Harmel* Does Not Support Respondent

Burnet v. *Harmel*, 287 U. S. 103 (1932), cited by respondent at pages 12, 19, *et seq.*, of his brief does not support the proposition that Section 117(a) is to be construed narrowly. That case specifically dealt with Section 208(a)(1) of the Revenue Act of 1924 wherein capital assets were defined in terms of a two-year holding period. The Revenue Act of 1934 abandoned the prior definition in enacting Section 117(b) "Definition of Capital Assets". The holding period no longer determined whether an asset is classified as capital or non-capital. All assets have since been designated as capital assets, *whether or not connected with taxpayer's trade or business*, unless specifically excluded.

The change in the statute would render *Burnet* v. *Harmel*, 287 U. S. 103 (1932) inapposite even if it

stood for the legal conclusion which respondent contends it does, but which petitioner denies. This Court there held that bonus payments received in addition to royalties in connection with an oil *lease* constituted ordinary income in the form of *rent*. The payments were required whether or not title technically passed to the oil in place on the execution of the lease; for this reason this Court held the transaction was not a sale. The Court did not thereby hold or even suggest that Section 208(a)(1) of the Revenue Act of 1924 defining "capital assets" was to be narrowly construed as respondent would have this Court believe. On the contrary this Court recognized the intent of Congress to relieve capital gains from high surtaxes, stating:

> "The provisions of the 1921 Revenue Act for taxing capital gains at a lower rate, re-enacted in 1924 without material change, were adopted to relieve the taxpayer from these excessive tax burdens on gains resulting from a conversion of capital investments, and to remove the deterrent effect of those burdens on such conversions. House Report No. 350, Ways and Means Committee, 67th Cong., 1st Sess. on the Revenue Bill of 1921, p. 10; see *Alexander* v. *King* (C. C. A.) 46 F. (2d) 235, 74 A. L. R. 174."

Respondent in interpreting *Burnet* v. *Harmel*, 287 U. S. 103 (1932), argues, at page 12 of his brief, that "the capital asset definition shall be broadly applied so as not to frustrate the Congressional purpose of

limiting the preferential treatment to property in the nature of investments, not employed as an integral part of the day-to-day income producing activity of the taxpayer".

On the other hand, respondent overlooks that the application of capital treatment is a penalty to the taxpayer in loss cases since loss deductions are limited thereby. Congress, in enacting the 1921 Act in the Report of the Ways and Means Committee, considered the loss aspect of the section more important than the gain aspect. For instance, the Ways and Means Committee of the House, in its Report (67th Congress, First Session, House Report 350) said:

> "It is believed that the passage of this provision would materially increase the revenue, not only because it would stimulate profit-taking transactions but because the limitation of 15 per cent is also applied to capital losses. Under present conditions there are likely to be more losses than gains" (pp. 10-11).

It should be further noted that the result forecast by Congress, as shown in the quotation above, has been eminently accurate in tax cases relating to hedging. In practically all the litigated cases the argument was addressed to loss treatment. Respondent's argument as to preference falls by its own weight when all aspects of capital asset treatment are considered.

4. The Present Case Does Not Involve an Attempt to Convert Ordinary Income to Capital Gain

The other cases cited by respondent in support of his theory of narrow and strict construction at pages 21 and 22 of his brief (*Kieselbach* v. *Commissioner*, 317 U. S. 399 (1943); *Hort* v. *Commissioner*, 313 U. S. 28 (1941); *Helvering* v. *Smith*, 90 F. (2d) 590 (2nd Cir., 1937); *Doyle* v. *Commissioner*, 102 F. (2d) 86 (4th Cir., 1939); *Rhodes' Estate* v. *Commissioner*, 131 F. (2d) 50 (6th Cir., 1942); *Fisher* v. *Commissioner*, 209 F. (2d) 513 (6th Cir., 1954), certiorari denied, 347 U. S. 1014 (1954); *Shuster* v. *Helvering*, 121 F. (2d) 643 (2nd Cir., 1941)) all involved attempts to convert ordinary income to capital gain by the sale or assignment of the right to receive it or the proper allocation of lump sum payments between proceeds of sale of capital assets on the one hand and ordinary income from services rendered or rental income on the other. In *Lucas* v. *Earl*, 281 U. S. 111 (1930), this Court had held that income is taxable to the person earning it and may not be assigned before receipt to convert it into a capital asset. The present case does not involve any such attempt to convert future income to capital gain. Here we are only concerned with purchases and sales of corn futures contracts which are admittedly capital assets (cf. Respondent's Brief, page 19).

Superficially the other cases cited by respondent, involving costs connected with the acquisition and dis-

posal of capital stock in whiskey distilleries (Respondent's Brief, pages 22-23) in order to acquire inventory, appear to be in point, but they are not. In each one of these cases inventory assets were acquired by the taxpayer by means of capital asset acquisitions, followed by the disposal of the stock. The instant case does not involve the acquisition of inventory assets but only futures contracts not held for sale to customers. (*Western Wine & Liquor Co.*, 18 T. C., 1090 (1952), appeal dismissed, 205 F. (2d) 420 (8th Cir.); *Clark* v. *Commissioner*, 19 T. C. 48 (1952), appeal dismissed June 18, 1953 (9th Cir.), and *Hogg* v. *Allen*, 105 F. Supp. 12 (M. D., Ga.), affirmed on this point, *sub nom.*, *Edwards* v. *Hogg*, 214 F. (2d) 640 (5th Cir., 1954)).

Despite all of the cases cited, respondent can only find one case in point which supports the theory he wishes to advance here. It is *Commissioner* v. *The Bagley & Sewall Co.*, 221 F. (2d) 944, 947 (2nd Cir., 1955), with which petitioner emphatically disagrees.

The precise reasons for disagreement are set forth at length in petitioner's initial brief at page 39 where it quotes in part Judge Frank's dissenting opinion in that case. Congress has nowhere stated or even indicated in enacting Section 117(a) or its predecessors that the purpose to which capital assets are put in any way changes their tax consequences. Congress has consistently defined capital assets to be *all assets whether or not used in the taxpayer's trade or busi-*

ness, unless they fall within the specific enumerated exclusions. *Richfield Oil Corporation* v. *State Board*, 329 U. S. 69 (1946); *Moore Ice Cream Company* v. *Rose*, 289 U. S. 373 (1933); *Cunard S. S. Co.* v. *Mellon*, 262 U. S. 100 (1923); *Addison* v. *Holly Hill Co.*, 322 U. S. 607 (1944); *Brooks* v. *St. Louis-San Francisco Ry. Co.*, 180 F. 2d 185 (8th Cir., 1950).

5. Assets Used in Hedging Are Not Excluded from Capital Assets

Respondent slides up to petitioner's proposition that hedging is not a proper exception to Section 117 in a rather oblique manner. Having contended (and we believe erroneously as we have discussed above) that there are additional exclusions to Section 117(a) other than the precise exclusions listed in the statute, he merely says in effect that this is just another one.

He again cites *Burnet* v. *Harmel*, 287 U. S. 103, 108 (1932); this time, however, suggesting a broad rather than narrow construction, he uses it to support his contention that not to permit the hedging exception "would have tended to defeat rather than further the purpose of the Act".

Respondent then cites all the cases in which G. C. M. 17322 (XV-2 Cum. Bul. 151) were involved in litigation as examples of the courts looking to the underlying purpose of the capital gains provision in interpreting Section 117. Petitioner has again reviewed those cases and nowhere do we find support for

respondent's implication or inference. An examination of these cases in detail will emphasize how narrowly and precisely the hedging rule has been applied by the lower courts, and it is noted that respondent has never discussed those decisions for the precise reason that they are precedents against his contentions in Section B of his brief (p. 31).

Respondent then makes the point that Congress has recognized that Section 117 does not apply to hedging transactions, by referring to the exclusions of hedging transactions from the general rule of Section 1233(a) of the 1954 Revenue Code. It is true that Section 1233(a) of the 1954 Code excepts hedging transactions in commodity futures from the operation of the short-sale rule. Section 1233 is the successor to Section 117(g) and Section 117(l) of the 1939 Code. It is not the successor to Section 117(a). It, therefore, becomes doubly significant that, while Congress made hedging an exception to the short-sale rule in enacting Section 1233 in 1954, it did not make any such exception in its exclusions from the definition of capital assets in Section 1221,[1] the successor to Section 117(a).

Congress has had repeated opportunities since 1934 to exclude *assets used in hedging transactions* from its definition of capital assets in each and every Revenue Act following that year. It has failed to do so. Congress at all times was cognizant of the

[1] Section 1221 of the 1954 Code: Appendix A, page 35.

concept of hedging as is seen in its treatment of profits from hedging transactions for personal holding company purposes in Section 502(c) of the Internal Revenue Code of 1939.

Congress set up a general definition in Section 117(a). It made specific exclusions therefrom. Congress has amended those exclusions from time to time. Congress has known that capital assets are and have been used in hedging transactions, but has not seen fit to make capital assets so used the subject of an additional exclusion. Every canon of statutory construction forbids an additional exclusion from being implied.

It is true, as respondent contends at pages 25 and 26 of his brief, that in the years following General Counsel's Memorandum No. 17322 (XV-2, C. B. 151 set forth at length at page 16 of petitioner's initial brief), the lower courts have applied that ruling to commodity transactions.[2] However, this Court has never passed upon the validity of G. C. M. No. 17322. The taxpayers, in those cases, claiming ordinary losses in their commodity transactions sought to take advan-

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[2] *Ben Grote*, 41 B. T. A. 247 (1940); *Commissioner* v. *Farmers & Ginners Cotton Oil Co.*, 120 F. (2d) 772 (5th Cir. 1941), cert. denied, 314 U. S. 683 (1941); *Kenneth S. Battelle*, 47 B. T. A. 117 (1942); *Tennessee Egg Co.*, 47 B. T. A. 558 (1942); *Trenton Cotton Oil Co.* v. *Commissioner*, 147 F. (2d) 33 (6th Cir. 1945), affirming T. C. Memo Op. (Dec. 28, 1943); *Estate of Dorothy Makransky*, 5 T. C. 397 (1945), aff. 154 F. (2d) 59 (3rd Cir. 1946); *Stewart Silk Corp.*, 9 T. C. 174 (1947); *Fulton Bag & Cotton Mills*, 22 T. C. 1044 (1954).

tage of G. C. M. No. 17322. Consequently, they did not wish or feel impelled to question the concept of hedging as an exception to Section 117(a).[3] The Commissioner, on the other hand, since he had issued the ruling, felt himself bound by his own ruling. Significantly, however, this General Counsel's Memorandum was never promulgated into regulation by the Commissioner. It, therefore, is not supported by the reenactment of Section 117(a). The present case presents the first opportunity for a taxpayer to challenge the validity of G. C. M. No. 17322 before this Court. The G. C. M. flies in the face of the statute which provides that assets are capital assets and remain as such *whether or not connected with the taxpayer's trade or business.*

B. Petitioner's commodity futures transactions do not fall within the so-called "Hedging Exception to Section 117".

Respondent has admitted repeatedly in his brief (pages 34, 38) that petitioner was not engaged in *true hedging* operations. Nevertheless, respondent states that this makes no difference (Brief, page 38). Petitioner wishes to emphasize the blatant inconsistency of respondent's position in this case from its prior position in all other cases. (See page 15, footnote 2).

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[3] See *Rich & Rippe, "Tax Aspects of Commodity Futures Transactions with a Business Purpose"*, 2 Tax Law Review 541 at 559, where the authors recognized the conflict between the statute and the concept.

1. Respondent Took an Inconsistent Position in Prior Cases

In *Commissioner* v. *Farmers & Ginners Cotton Oil Co.*, 120 F. (2d) 772 (5th Cir., 1941) the Court held that the taxpayer's losses did not result from *true hedging* operations and limited the taxpayer to capital loss treatment. Thereupon the taxpayer filed a petition for certiorari (*Farmers & Ginners Cotton Oil Co.* v. *Commissioner*, 314 U. S. 683 (1941)). The Commissioner made the following argument to this Court in successfully resisting taxpayer's application for certiorari. We quote from page 7 of his brief in that case:

> "2. Section 117(b) makes no exception for hedging transactions nor has any exception been made therefor by Treasury Regulations. However, it has been the practice to permit deductions in full upon losses from *true hedging* transactions. The theory is that hedging is a form of insurance of normal business profits against the risk of fluctuations in the market price of the product in which the taxpayer deals or in the market price of the materials which are used by him to make that product. But this case does not present a *true hedging* transaction." (Emphasis supplied.).

This statement repeated the argument previously made by respondent in his brief in the Court of Appeals below in the same case at pages 10 and 11 as follows:

> "It (the taxpayer) was merely assuming an-

other new and different risk, and it thus becomes a speculator and not a hedger in the refined cottonseed oil futures market. The taxpayer was endeavoring to recover or recoup a loss from a risk which it had assumed but not protected itself against by hedging. That was not hedging or insuring against a loss and the reason for permitting the deduction in full of losses from hedging did not exist."

Nor was this a mere transitory position taken by the Commissioner. In *Trenton Cotton Oil Co. v. Commissioner*, 147 F. (2d) 33 (6th Cir., 1945), rehearing denied, 148 F. (2d) 208 (6th Cir., 1945), respondent made the following argument in his answering brief in that case at page 8:

"If the losses are *true hedging losses*, they are considered to be deductible in full as ordinary and necessary business expenses under Treasury practice, but if the losses are from speculative transactions, they are losses from sales of capital assets and may be deducted only to the extent of $2,000 plus gains from such sales under Section 117(d) * * *." (Emphasis supplied.)

At page 9 of the same brief:

"There can be no question that the futures contracts are the type of property embraced by the definition of 'capital assets' in Section 117(a)(1) of the Revenue Act of 1938 * * *."

Again at page 10 of the same brief:

> "The contracts to buy and sell refined cottonseed oil for future delivery were property held by the taxpayer and not one of the four types of property expressly excluded by the statute from the definition of capital assets. Consequently, unless the dealings in the contracts are *true hedges,* the futures contracts are capital assets. *Commissioner* v. *Farmers & Ginners Cotton Oil Co.,* 120 F. (2d) 772, (C. C. A. 5th), certiorari denied, 314 U. S. 683; *Commissioner* v. *Covington,* 120 F. (2d) 768 (C. C. A. 5th), certiorari denied, 315 U. S. 822; *Commissioner* v. *Bamfield,* 122 F. (2d) 1017 (C. C. A. 9th). See also *Farmers & Ginners Cotton Oil Co.* v. *Commissioner,* decided March 3, 1942 (1942 P-H B. T. A. Memorandum Decisions, par. 42,120) affirmed 130 F. (2d) 941 (C. C. A. 5th) on authority of former opinion reported at 120 F. (2d) 772; *Tennessee Egg Co.* v. *Commissioner,* 47 B. T. A. 558." (Emphasis supplied.)

Respondent is now taking the reverse position that the existence or nonexistence of a *true hedge* is of no consequence whatever (Brief 38). Respondent argues that because petitioner protected itself against a rise in corn prices it should be treated as if it were hedging, denominating such action as "partial insurance" (Brief 35).

2. Petitioner Merely Shifted the Risk of Loss

All petitioner did by buying corn futures contracts was to exchange protection from the risk that the price of raw corn would decline for protection against the opposite risk that the price of raw corn would rise. Respondent has recognized this in his brief at page 14 in the statement of facts. If any taxpayer buys any property at any time, it shifts from a risk that the property will rise in price, to a risk that the property will decline in price. This is not hedging in any respect; it is not insurance; it merely is an exchange of risks. By the very same token if petitioner had never purchased a corn future, by doing absolutely nothing, it would have protected itself against the risk that the price of corn would decline. It would not have protected itself against the risk that the price of corn would rise. To designate such inaction as in the nature of a hedge because petitioner would be protected against a decline in the price of corn but not a rise in the price, spotlights the poor logic of the respondent's position. This is not "insurance" in any sense of the word.

Respondent, at page 35 of his brief, has stated that the "principal risk" against which petitioner sought to protect itself was that the price of corn would rise. The record will not substantiate that there was a principal risk. The stipulation of facts (R. 221) shows the gains and losses for all years from 1932 through 1942, inclusive. The figures show that there

were net gains in five different years totalling $1,535,282.97 and net losses in six years totalling $1,546,795.51. This demonstrates that the risk was substantial in either direction.

3. Respondent's Two Charts Are Misleading

a. Chart No. 1

Chart No. 1 is an adaption of the chart appearing in petitioner's initial brief which respondent says is misleading. Respondent has taken petitioner's chart (Brief, page 9), which was prepared from statistical information in the record, and so rearranged it as to confuse rather than to clarify the basic facts in this case.

Respondent has attempted to match corn futures owned against orders on hand to show their broad relationship to one another, completely disregarding the fact that petitioner had sufficient raw corn and finished stocks on hand to offset its orders except for minor amounts at April 1, 1940, July 1, 1941, October 1, 1942 and December 24, 1942. The record discloses that petitioner had 2,303,000 bushels of storage capacity for its raw corn at all times pertinent (R. 33). While there is nothing in the record directly on this point it is inconceivable that petitioner's plants at any time had no products in process of manufacture during the years in question (the contrary is demonstrable from the Tax Return (Joint Exhibit 12-H, R. 78, 116)).

Petitioner in computing the quantity of available inventory on hand to fill orders had three sources to look to, not merely to its stocks of finished goods as argued by respondent, *i. e.* raw corn, goods in process, and finished stocks. Petitioner's chart, prepared on a cumulative basis, thus demonstrates the true situation (Brief 9).

Respondent has therefore drawn an erroneous conclusion that there was "a broad relationship between taxpayer's holdings of futures and its orders on hand" (Brief 37).

b. Chart No. 2

Commissioner's Chart No. 2 is an attempt to make an inverse correlation between petitioner's futures position and commercial corn carry-overs at terminal markets to prove petitioner reduced its futures position as the corn carry-over increased. The chart in point of fact proves nothing and tends to confuse. It should be noted that the total carry-over in all terminal markets in the United States in 1941 was only 40,000,000 bushels and slightly less in 1942 as shown on Commissioner's Chart No. 2. The stipulated facts (Exhibit 2-B, R. 224, 231) show how insignificant this carry-over was. Petitioner alone, one consumer of raw corn among many thousands, used over 54,000,000 bushels of corn in 1941 and over 60,000,000 bushels of corn in 1942. This was more than the total national carry-over in each year. In other words, petitioner

alone could have consumed the entire corn carry-over if it were available.

The insignificance of the carry-over is further demonstrated by the following figures taken from the United States Statistical abstract, 1949 Edition, page 668, which shows: that the total corn crop in 1941 was 2,651,000,000 bushels, and in 1942 was 3,068,000,000 bushels. The carry-over was a mere one and a half percent of the corn crop in 1941 and less in 1942. In any event the degree of inverse correlation is a pure coincidence. The record shows that the reduction in petitioner's corn futures position starting in 1940 was the result of the outbreak of war (R. 54).

4. The Commodity Exchange Authority Has Held Petitioner Was Not Hedging

Respondent points out, page 41 of his brief, that in the 1952 Commodity Exchange Authority proceeding, petitioner stated it was able to forecast what its sales would be for months ahead. There is nothing in the present record to indicate that forecasts of sales were made in the period from 1936 to 1942. As a matter of fact this forecasting technique was developed subsequent to World War II.

Most significantly, the Secretary of Agriculture held in that proceeding that even though petitioner was able to forecast its sales and even though petitioner was balancing its purchases of corn futures contracts with short sales of cane sugar futures contracts, *it still*

was not hedging. It is an "*a fortiori*" conclusion that if petitioner was not hedging in 1952 even with these additional elements, it could not have been hedging in the years here involved when such elements were not present.

The Government urges in its brief in the appeal from the Commodity Exchange Authority holding (now pending before the Court of Appeals for the 2nd Circuit) at page 21 thereof:

> "There is no existing fixed price obligation in the cash market which would afford the basis for a purchase of futures contracts as a hedge. This is obvious with respect to the petitioner's anticipated manufacturing requirements and expected sales, and is equally apparent with respect to the petitioner's contracts to sell at a price to be determined later."

Again at page 37 of its brief on that appeal the Government argues:

> "Hence the petitioner's attempt to demonstrate that a hedge consists of a purchase of futures contracts to offset some transaction that is *expected to occur* at a later date is *squarely contrary to the fundamental principles of hedging.*" (Emphasis supplied.)

It therefore follows that the forecasts of sales which petitioner was able to make in 1952 would not alter the fact that petitioner was not hedging and could not hedge.

5. Taxpayers' Intent Is of No Significance

Respondent alludes (Br. 39) to the testimony of the witness Hall as to the intent of the taxpayer in entering into commodity futures transactions (R. 72, 73, 76). The cases cited at Footnote 2, page 15 of this brief, are amply clear that the *purpose or intent* of a taxpayer will not govern in determining whether a commodity futures transaction is to be treated as a capital asset transaction or as an ordinary one. In each case, the taxpayer intended to hedge and thought he was hedging. The courts' decisions, nevertheless, ignored intent. The courts based their findings solely on the facts as developed, i. e., whether or not the taxpayers were engaged in "*true hedging*" operations. If not, even though the taxpayers actually thought they were hedging, the transactions were treated as capital losses. *Estate of Dorothy Makraunsky*, 5 T. C. 397 (1945) affirmed 154 F. (2d) 59 (3rd Cir., 1946); see also *Tennessee Egg Co.*, 47 B. T. A. 558 (1942).

It is also a matter of no importance that the taxpayer treated the transactions originally as part of cost of goods sold. When the Commissioner in 1940 proceeded to urge the theory of *true hedging* as the controlling factor and won the series of cases previously cited at page 22 of petitioner's initial brief, this taxpayer was compelled to reconsider its position and to conform it with the law as it then understood it. Furthermore, with the sole exception of this

present proceeding, The Tax Court and the other lower courts have adhered consistently to the test of *true hedging*. Even as recently as *Fulton Bag & Cotton Mills;* 22 T. C. 1044 (1954), which was subsequent to its decision in the instant case, The Tax Court reaffirmed that test.

Petitioner's chart (initial brief, page 9) and Commissioner's Chart No. 1 both show that at the precise time when petitioner had the largest amount of orders on hand, it had the least amount of corn futures contracts (July 1, 1941). However, in the period from July 1, 1938 through July 1, 1939 when it had the smallest amount of orders on hand it had the largest amount of futures contracts. This is an inverse correlation and demonstrates that petitioner's futures contracts position did not relate to nor tie in with its customers' orders.

6. Petitioner—the Legitimate Capitalist

Respondent belittles petitioner's contention that it falls within the category of a "legitimate capitalist" in spite of the fact that this Court in *United States* v. *New York Coffee & Sugar Exchange, Inc.*, 263 U. S. 611 (1924), pointed out that persons dealing in futures must be classified in not two, but three separate classes:

1. "Those who use them to hedge";
2. "Legitimate capitalists who, exercising their judgment as to the conditions, purchase or sell

for future delivery with a view to profit based on the law of supply and demand";

3. "Gamblers or irresponsible speculators who buy or sell as upon the turn of a card."

Petitioner's commodity futures position during the years here in question represented the exercise of judgment by its officers that the interests of the company would best be protected by maintaining a long position in the event that a repetition of the terrible droughts of 1934 and 1936 might recur (R. 51 and 52).

Petitioner was in the same position as a manufacturer of wood products who, realizing that timber might become scarce, buys an area of timberland with the intention of using it in production if the scarcity of lumber develops. Later it sells that land and timber, finding that it has sufficient lumber from its normal sources to cover its requirements. Would respondent say that because the timber might have been used by the manufacturer as part of its raw material, he should exclude it from the category of capital assets, just as he now contends in the case of unneeded corn futures? In the present case, when petitioner took delivery of corn upon the maturity of a corn futures contract it included the cost in inventory and subsequently it became a part of the cost of goods sold (R. 80). When petitioner did not require the corn, it disposed of the contract in the same manner that the manufacturer disposed of the unneeded timberland.

7. Conclusion

The phrase adopted by The Tax Court as decisive in this case, to wit, "an integral part of its manufacturing business" finds no support in Section 117(a) which specifically defines capital assets whether or not used in the taxpayer's business. As is indicated herein above and in petitioner's original brief, it is believed that if this Court sustains respondent's theories and those of the Courts below on this point, great uncertainty in the administration and application of the capital limitations provision will follow. In addition it will result in a substantial reduction to the revenue.

The uncertainty will stem directly from the question of what degree of proximate relationship with the taxpayer's trade or business is required to characterize an asset for tax purposes as ordinary rather than capital. Congress certainly was aware of this problem when it originally enacted and later revised the statute. For had it not considered this problem, the history of these provisions would not have developed as it has. Most assets of proprietorships and partnerships and all those of business corporations have some relationship to the business conducted by such entities. If respondent is sustained all losses whether capital or otherwise will be claimed as ordinary deductions by such entities and the litigation and confusion resulting therefrom will be enormous.

That a very considerable number of capital losses will be allowed as ordinary deductions seems indisputable, for the impossibility of respondent's policing such an imprecise test as the proximate relationship of any given asset to the trade or business in question cannot be doubted. It might be argued that Congress could remedy such a result by some specific legislation, but that view itself does not bear close inspection for the test already in the statute is precision itself.

II

Commodity futures transactions are subject to the wash sales provisions of Section 118 of the Internal Revenue Code.

A. The futures contracts purchased and sold were substantially identical.

Petitioner and respondent are both in agreement that the purpose of Section 118 was to prevent the taking of a "paper loss" in order to acquire a tax advantage where the taxpayer did not truly alter his economic position (Respondent's Brief, page 48). Petitioner and respondent are also in agreement that corn futures contracts mature in different months within any given year.

The point of difference between petitioner and respondent lies in the fact that petitioner claims and respondent denies that a corn futures contract requir-

ing May delivery is "substantially identical" to a corn futures contract requiring July delivery, and that a July delivery is "substantially identical" to a September delivery.

The statistics supplied by respondent himself at page 50 of his brief show that on January 2nd, 1942, the high of the May delivery prices differed from the low of the July delivery prices by less than one cent. They further show that the high of July differed from the September low of the same year by only ¼ cent. Respondent makes the error of insisting not on *substantial identity* as provided in Section 118, but on *absolute identity*. Petitioner in moving its position forward from one futures contract to the next is not changing or altering its economic position. It is merely continuing it. This is the precise situation to which Section 118 was directed.

It is true that in the year of a drought or in the year following a drought prices of commodities bearing maturities within a twelve-month period will vary, but these are the exceptional situations. The proof in this case is that the futures contracts purchased by petitioner were *substantially identical* to those sold (R. 90), and respondent's statistical information for the year 1942 (Brief, page 50) bears this out. Thus, between November 2nd and December 1st, 1942 the statistics show that December futures rose five and a fraction cents; so did May futures and so did July futures. This establishes "substantial identity".

B. Futures contracts are securities within the meaning of the term as used in Section 118.

Petitioner relies on the decision of the Court of Appeals for the 6th Circuit in *Trenton Cotton Oil Co.* v. *Commissioner*, 147 F. (2d) 33 (6th Cir., 1945). Respondent, on the other hand, while admitting (Br. 48) that the purpose of Section 118 is to close the "paper loss" loophole, would only close the loophole in the case of stocks and bonds, leaving it wide open where commodity futures are involved. Was the intent of Congress only to close the loophole partially and *lose revenue* thereby? Respondent does not deny that commodity futures trading on regulated exchanges is as extensive as trading in securities; nor does respondent deny that the same broker can execute both types of transactions on the same floor of the Chicago Board of Trade (R. 94).

Respondent urges that because commodity futures contracts mature within eleven months, the evil of paper losses does not exist (Brief, page 55). Respondent has failed to consider that a short-term loss in stocks, where the security is held for less than six months, can result in a "wash sale" in the same manner and with identical effect as in the case of long-term securities. In both cases the loss is disallowed under Section 118. The period for which the speculator may hold the stock, the bond, or the commodity futures contract is immaterial. He can have a paper

loss within days, weeks or months, as well as within years. There is nothing in the statute to indicate that the evil Congress sought to correct only involves the long-term investor, as respondent contends (Brief, page 55).

Respondent, at page 51, *et seq.*, has cited Section 4(c) of the Commodity Exchange Act which forbids wash sales, cross sales, accommodation trades and fictitious sales. The term "wash sale" as used in that statute is not the same "wash sale" referred to in Section 118. It is, as the statute points out, commonly known to the trade as a *fictitious* sale, whereas a wash sale in tax parlance is a *real* sale. A "wash sale" under Section 118 occurs where a taxpayer acquires the same long position within thirty days before or after a sale at a loss. If the sale results in a gain, the gain is recognized and taxed. *Valley Waste Mills* v. *Page*, 115 F. (2d) 466 (5th Cir., 1940), certiorari denied, 312 U. S. 681 (1941); *Harriss* v. *Commissioner*, 143 F. (2d) 279 (2nd Cir., 1944). The Commodity Exchange Act definition is, therefore, not controlling on this point, since the two statutes deal with diverse transactions.

In conclusion, petitioner submits that the same evil exists in the allowance of "paper losses" from transactions in stocks, bonds and commodity futures contracts, all of which are sold on regulated exchanges on margin. It is this evil that the Court recognized

in *Trenton Cotton Oil Co.* v. *Commissioner*, 147 F. (2d) 33 (6th Cir., 1945), affirming T. C. Memo. Op. (Dec. 28, 1943), as the evil which Congress sought to correct.

CONCLUSION

It is urged that for the foregoing reasons the judgment of the Court below should be reversed.

Respectfully submitted,

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Dated: October 14, 1955

APPENDIX A

SEC. 1221. CAPITAL ASSET DEFINED. (Internal Revenue Code of 1954.)

For purposes of this subtitle, the term "capital asset" means property held by the taxpayer (whether or not connected with his trade or business), but does not include—

(1) stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business;

(2) property, used in his trade or business, of a character which is subject to the allowance for depreciation provided in section 167, or real property used in his trade or business;

(3) a copyright, a literary, musical, or artistic composition, or similar property, held by—

(A) a taxpayer whose personal efforts created such property, or

(B) a taxpayer in whose hands the basis of such property is determined, for the purpose of determining gain from a sale or exchange, in whole or in part by reference to the basis of such property in the hands of the person whose personal efforts created such property;

(4) accounts or notes receivable acquired in the ordinary course of trade or business for services rendered or from the sale of property described in paragraph (1); or

(5) an obligation of the United States or any of its possessions, or of a State or Territory, or any political subdivision thereof, or of the District of Columbia, issued on or after March 1, 1941, on a discount basis and payable without interest at a fixed maturity date not exceeding one year from the date of issue.